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IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

NEWARK MORNING LEDGER CO.,
as successor to THE HERALD COMPANY,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Third Circuit

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BRIEF OF INDEPENDENT INSURANCE AGENTS OF AMERICA, NATIONAL ASSOCIATION OF CASUALTY & SURETY AGENTS, NATIONAL ASSOCIATION OF INSURANCE BROKERS, AND NATIONAL ASSOCIATION OF PROFESSIONAL INSURANCE AGENTS, AS *AMICI CURIAE*, IN SUPPORT OF PETITION

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INTRODUCTION

This brief is filed on behalf of the Independent Insurance Agents of America, the National Association

of Casualty & Surety Agents, the National Association of Insurance Brokers, and the National Association of Professional Insurance Agents (the "*Amici*") to respectfully urge this Court to grant Petitioner's Petition for a Writ of Certiorari. The written consents from the parties to the filing of this brief are attached.

INTERESTS OF THE *AMICI CURIAE*

Independent Insurance Agents of America is the nation's largest independent insurance agent association, representing over 220,000 agents and their employees. Its members offer all lines of insurance, including property, casualty, life, and health insurance.

The National Association of Casualty & Surety Agents represents 300 of the nation's leading insurance agencies and brokerages specializing in the sale and service of commercial insurance products to business, industry and municipalities.

The National Association of Insurance Brokers ("NAIB") is the national trade association of commercial insurance brokers. Founded in 1934, its members range in size from large international companies to regional and local firms representing clients throughout the United States and around the world. NAIB members administer the majority of all commercial property and casualty insurance in the United States.

The National Association of Professional Insurance Agents ("PIA") is a nonprofit trade association, representing 180,000 independent insurance agents and their employees who sell and service all lines of in-

surance, specializing in coverage for homes, automobiles and business. PIA is represented throughout the United States and Puerto Rico by members affiliated with forty-one PIA state or regional associations.

The *Amici* have a particular interest in this case for several reasons. First, given the nature of the insurance industry, substantial economic value is attributed to intangible assets such as policy expiration lists and customer lists. Accordingly, the holding of the Third Circuit directly and adversely would affect the federal income tax treatment of many members of the *Amici*. Second, the Third Circuit's decision, because it is in direct conflict with the holdings of other circuits, will result in disparate tax treatment among members of the *Amici*, depending upon the happenstance of business location. Third, because the Third Circuit's decision is at odds with the applicable tax statutes, it creates substantial uncertainty in the treatment of customer-based intangible business assets that have an ascertainable value and limited useful life.

This case presents the important federal income tax issue of whether terminable-at-will customer relationships acquired in the purchase of a going concern are depreciable under section 167 of the Internal Revenue Code. 26 U.S.C. § 167 (1986), as amended ("I.R.C."). This issue arises continuously in business acquisitions and dispositions of customer-based intangible assets by the members of the *Amici* and involves billions of tax dollars. Indeed, a recent General Accounting Office study, which specifically refers to the significance of intangible assets in the insurance industry as well as in other customer service industries, notes that

taxpayers have claimed depreciation deductions for $10.5 billion of customer-based assets and that the Internal Revenue Service has proposed adjustments in those matters aggregating over $4 billion in taxes. United States General Accounting Office, *GAO/GCD-91-99 Tax Policy, Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets (Aug. 1991).*

STATEMENT OF THE CASE

This case concerns specifically whether a depreciation deduction under I.R.C. section 167 may be taken by the Newark Morning Ledger Company (hereinafter "Morning Ledger") for the portion of the purchase price of eight Michigan newspapers which is allocable to identifiable subscriber relationships. The amount of the purchase price for those "paid subscribers" reflected an acquisition of distinct "customer-based" intangible assets.

To prevail on its claim for a depreciation deduction, Morning Ledger bore the burden of showing that the subscriber relationships had: (1) an ascertainable value separate and distinct from goodwill; and (2) a limited useful life that could be estimated with reasonable accuracy. App. A at 9a.[1] The Third Circuit accepted that Morning Ledger had shown that the intangible assets constituting the "paid subscribers" had (1) limited useful lives that could be estimated with reasonable accuracy, and (2) ascertainable value. However, the court further held that the subscription relationships were not "separate and distinct from goodwill"

[1] References are to pages of the Appendix to the Petition for a Writ of Certiorari.

because they reflected an "expectation of continued patronage" and, accordingly, were not depreciable. App. at 11a, 28a-29a. The court based its decision on the grounds that the "paid subscribers" were acquired by Morning Ledger in the purchase of an ongoing business and that the subscriptions were not "contractually-based." App. at 11a and 17a. Further, the court suggested that the intangible assets were not depreciable because Morning Ledger used an improper method of valuing the assets. App. at 30a.

The Third Circuit's decision announces a startling rule that conflicts with the rule in other circuits and that effectively creates a presumption that will be difficult, if not impossible, to refute—that customer-based intangible assets acquired as part of an ongoing business inherently are part of goodwill and, therefore, nondepreciable.[2] This rule unjustifiably elevates transactional form over substance. Moreover, it is in direct conflict with the law in the Fifth, Seventh, Eighth, Eleventh and Federal Circuits and the full Tax Court,[3] and is inconsistent with Congressionally recognized sound tax policy. In short, it fails to account for business and economic realities.

[2] It is not entirely clear whether the Third Circuit held such assets to be nondepreciable as a matter of law or whether, instead, it restated the applicable law to elevate a taxpayer's burden to the point that it would be incapable of proving that these assets are separate and distinct from goodwill.

[3] *See Donrey, Inc. v. United States*, 809 F.2d 534 (8th Cir. 1987); *Houston Chronicle Publishing Company v. United States*, 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974); *Super Food Services, Inc. v. United States*, 416 F.2d 1236 (7th Cir. 1969); *Richard S. Miller & Sons, Inc. v. United States*, 537 F.2d 446 (Ct. Cl. 1976); *Citizens & Southern Corp. v. Commissioner*, 91 T.C. 463 (1988), *aff'd*, 919 F.2d 1492 (11th Cir. 1990).

In arriving at its conclusion, the Third Circuit focused on the definition of "goodwill," accepting a "traditional" formulation that goodwill is "the expectation of continued patronage." App. at 10a-11a. Observing that "the projected stream of income to be generated by the 460,000 at-will subscribers is simply a quantification of Morning Ledger's expectation that these subscribers will continue their patronage," the Third Circuit held that the amount allocable to the "paid subscribers" constituted nondepreciable goodwill even though these intangible assets were shown to have limited useful lives that could be estimated with reasonable accuracy and ascertainable values.

REASONS FOR GRANTING THE PETITION

1. Certiorari Should be Granted to Resolve a Conflict Among the Circuits

The Third Circuit failed to recognize that the many authorities which refer to the "traditional" definition of goodwill fall into three categories: (a) cases of dated vintage that applied the now-repudiated "mass asset rule;"[4] (b) cases that resolve the depreciation issue on the ground that the taxpayer failed to carry its burden of proof (in establishing a limited useful life or

[4] Indeed, the Third Circuit's line of reasoning to the effect that "goodwill = expectancy of continued patronage = customer lists = goodwill" is virtually indistinguishable from the quintessential articulation of the discredited "mass-asset rule" contained in *Golden State Towel and Linen Service, Ltd. v. United States*, 373 F.2d 938, 942-44 (Ct. Cl. 1967). *See* App. at 14a n. 7.

an ascertainable value); and (c) cases in which the taxpayer carried its burden of proof and was, thus, entitled to depreciate intangible assets.[5] Many courts have reconciled the definition of goodwill with the allowance of depreciation deductions for discrete customer-based intangible assets acquired as part of an ongoing business if the taxpayer were to meet its burden. Indeed, that is the law in several circuits and in the Tax Court. *See, e.g., Citizens & Southern Corp. v. Commissioner*, 91 T.C. 463 (1988), *aff'd*, 919 F.2d 1492 (11th Cir. 1990); *Donrey, Inc. v. United States*, 809 F.2d 534 (8th Cir. 1987); *Super Food Services, Inc. v. United States*, 416 F.2d 1236 (7th Cir. 1969); *Computing & Software, Inc. v. Commissioner*, 64 T.C. 223 (1975), *acq.*, 65 T.C. 1153 (1976); *Los Angeles Central Animal Hospital, Inc. v. Commissioner*, 68 T.C. 269 (1977).

The Third Circuit essentially ignored the evolution of law from a *per se* (or "mass asset") rule—that customer-based intangible assets are so inextricably linked to goodwill as to be nondepreciable as a matter of law—to a recognition that such assets properly are depreciable in view of "the realities of modern business technology in a day when lists are bartered and

[5] A large part of the court's attention was focused on the *Houston Chronicle* case. App. at 8a-19a. It is inexplicable, though, how the Third Circuit considered the *Houston Chronicle* case to have conclusively buried "the notion that some intangible assets, although not necessarily goodwill, were nonetheless so intertwined with goodwill as to be nondepreciable as a matter of law in all cases—i.e., the mass asset rule" (App. at 16a), while at the same time it found *Houston Chronicle* to be the jurisprudential source for the conclusion that the subscription lists *necessarily* are goodwill if they are acquired as part of a going concern.

sold as discrete vendible assets." *Houston Chronicle*, 481 F.2d at 1253.

As noted by the Seventh Circuit:

> It is immaterial that the contracts may have no fixed termination date. [citations omitted] In our view, . . . it is also immaterial whether these [terminable-at-will] contracts were acquired separately or as part of a going business. Any quarrel with the going concern value of contracts acquired as part of a business is properly directed to the allocation to be made between goodwill and the contracts purchased and should not be relied on as requiring a complete denial of the depreciation deduction to contracts shown to have a limited useful life.

Super Food Services, Inc., 416 F.2d at 1240.

In the present case, the Third Circuit, in rejecting the holding of other circuits and, specifically, in "respectfully disagree[ing]" with the Eleventh Circuit's recent decision in *Citizens & Southern Corp.*, reverted to withering remnants of the mass asset rule. In so doing, the Third Circuit has created a clear conflict among the circuits.

2. Certiorari Should be Granted Because the Third Circuit's Decision is Inconsistent with Tax Policy

A fundamental premise of United States tax policy is that income should be matched, to the extent possible, with expenses incurred to reach a reasonable determination of net (or taxable) income. The Third Circuit's decision undermines that policy.

Ordinarily, a buyer of an ongoing business that has stable, existing customer relationships would expect to earn income from those existing customer accounts. That income stream typically is quantifiable with reasonable certainty over the remaining useful life of the acquired customer accounts. Accordingly, a buyer invariably would take into account the value of those customer relationships, as it would the value of tangible personal property, such as supplies and equipment, in determining the price it would pay for the business.

Under the Internal Revenue Code, depreciation deductions are allowable in reaching a true net income, permitting a taxpayer to offset revenues by a part of the price paid for "wasting" assets. I.R.C. § 167; Treas. Reg. §§ 1.167(a)-1 (1972); 1.167(a)-3 (1960). This allowance accounts for the exhaustion of assets used in business. It is intended to provide a deduction that correlates to the income-producing life of the asset. Thus, as a matter of sound tax policy, a taxpayer should be entitled to recover, through depreciation deductions, the allocable cost of customer-based intangible assets if those assets are shown to have a limited useful life, estimated with reasonable accuracy, and an ascertainable value.[6] That an intangible asset can be shown to have a limited useful life serves to distinguish it from nondepreciable goodwill.

Denying a taxpayer, such as Morning Ledger, the recovery of the cost of a wasting asset that has a

[6] This approach also is consistent with Generally Accepted Accounting Principles which are drawn to reflect economic income. AICPA Accounting Principles Board Opinion No. 17.

determinable value separate and distinct from goodwill and a limited useful life is wholly inconsistent with sound tax policy. It results in an overstatement of income. That result is inconsistent with the fundamental premise of the federal income tax system—to tax only *net* income.

In reaching a decision that is inconsistent with tax policy, the Third Circuit also unfairly discriminates against service industries. In a manufacturing business, a portion of the income stream expected to be generated by equipment, for example, would be reflected in the value of the tangible property, i.e., the manufacturing equipment. In service industries, such as the insurance industry of the *Amici*, a major portion of the value of a business is reflected in contractual relationships with customers—whether or not terminable-at-will. Similar to the subscriber relationships purchased by Morning Ledger, insurance businesses create substantial value through policyholder relationships. To deny depreciation deductions for these intangible assets unfairly and improperly would deprive the service industries of tax benefits allowable to other industries.

Furthermore, a careful review of the historic underpinnings for disallowing depreciation deductions for goodwill suggests strongly that the scope for defining "goodwill" for tax purposes should be narrowly limited. The proscription against amortizing goodwill originally appeared in an amendment to Article 163 of Treasury Regulation 69. T.D. 4055, VI-2 C.B. 63; Regs. 69, Art. 163 (Revenue Act of 1928). That amendment was prompted by a case that concerned whether a decline in the value of goodwill of a brewery attributable to the onset of Prohibition justified

a deduction. In that litigation, this Court overruled the Second Circuit,[7] and held that goodwill was not amortizable. *See Clarke v. Haberle Crystal Springs Brewing Co.*, 280 U.S. 384 (1930). That, however, is a far cry from the issue in the present case.

In light of this history, and accepting that the objective of our tax system is that *net* income accurately should be measured, sound tax policy argues strongly in favor of narrowing, rather than broadening, the definition of goodwill. Accordingly, the Third Circuit erred in expanding the definition to include all intangible assets that contribute to the expectancy of customer patronage, even though those assets have a limited useful life and an ascertainable value.

3. Certiorari Should be Granted Because the Third Circuit's Decision Creates an Unsupportable Distinction in Treatment of Customer-Based Intangible Assets

Routinely, in the insurance industry as in the newspaper industry, customer-based intangible assets—such as subscription lists, insurance expiration lists, policyholder lists, and other existing customer accounts—can be and are purchased separately from an ongoing business. Frequently, though, such assets are acquired as part of the purchase of a going concern. The Third Circuit apparently conceded that if such intangible assets are purchased separately they properly may be amortized for federal income tax purposes. App. at 17a. But, the court distinguished instances in which those same assets are purchased as part of an ongoing business, suggesting that the assets lose their identity and are transformed into unamortizable goodwill. *Id.*

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[7] *Haberle Crystal Springs Brewing Co. v. Clarke*, 30 F.2d 219 (2d Cir. 1929).

This distinction unjustifiably elevates the form of a transaction over its substance. Rather, the proper perspective has been noted by the Fifth Circuit in *Houston Chronicle*, "[a]mortizability for tax purposes must turn on factual bases—[this view] is more in accord with the realities of modern business technology in a day when lists are bartered and sold as discrete vendible assets." *Houston Chronicle*, 481 F.2d at 1253. Whether those assets are sold as idle assets of a defunct company or as assets of a going concern has no relevance to determining whether they are depreciable.

4. Certiorari Should be Granted Because the Third Circuit's Decision Disregards Acceptable Valuation Methods

The Third Circuit's decision effectively forecloses use of acceptable, and in some instances required, methods for distinguishing customer-based intangible assets from goodwill and for valuing those intangible assets. Specifically, the holding restricts, if it does not render wholly unavailable, the use of the "residual method" for separating customer-based intangible assets from goodwill. It further limits taxpayers to use of the "cost method" of valuing intangible assets, effectively proscribing use of the income stream, or capitalization of earnings, method.

The residual method for allocating the purchase price of multiple assets, which method in many instances is *mandated* by law, provides for the allocation of value to all assets *other than* goodwill, including intangible assets whether or not depreciable, *before* making an allocation to goodwill. *See* 26 U.S.C. §§ 338(b)(5), 1060 (1986); Treas. Regs. §§ 1.338(b)-2T(b) (1986); 1.1060-1T(d)(1988). The Third Circuit apparently was unaware that the Congress not only has approved use of the residual method to value goodwill separately from intangible assets, but in fact has *required* such treatment. Moreover, case law preceding the enactment of I.R.C. sections 338 and 1060 (including, curiously, a Third Circuit decision) applied the residual method to determine goodwill in appropriate circumstances.[8]

Further, in enacting I.R.C. section 1060, Congress explicitly recognized that the income stream, or capitalization of earnings, method for determining allocable value is a commonly accepted method of asset valuation for the purpose of determining tax basis in an acquisition of a going business.[9] In its ruling, however, the Third Circuit effectively denied use of the income stream method, opining that Morning Ledger "gambled" in its use of that method. App. at 30a. To the contrary, Morning Ledger used a method, supported with expert testimony, that is commonly accepted and, indeed, approved by Congress.

The court compounded its error in suggesting that *if* Morning Ledger has used the cost method, the

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[8] *See, e.g., Jack Daniel Distillery v. United States*, 379 F.2d 569, 579 (Ct. Cl. 1967); *R.M. Smith, Inc. v. Commissioner*, 69 T.C. 317, 320-323 (1977), *aff'd*, 591 F.2d 248 (3d Cir.), *cert. denied*, 444 U.S. 829 (1979). The residual method generally has been viewed as more favorable to the government than alternative methods because it typically results in a greater allocation to goodwill. *See Philip Morris, Inc. v. Commissioner*, 96 T.C. No. 23 (1991).

[9] S. Rep. No. 313, 99th Cong., 2nd Sess., p. 252 (1986). *See also General Explanation of the Tax Reform Act of 1986* (Committee Print, 1987) at 356 (explaining the status of the law prior to enactment of section 1060).

intangible assets would have become depreciable. The error in the court's reliance on the cost method and rejection of the income stream method is revealed in the facts. At trial, the lower court found:

> In response to the expert opinions submitted by plaintiff, [the Service] offered experts who were unqualified, valued the wrong asset and utilized inappropriate methodology.

Newark Morning Ledger Co. v. United States, 734 F. Supp. 176, 181 (D.N.J. 1990). That the Service's experts valued the "wrong asset" underscores the deficiencies of applying the cost method in valuing intangible assets and highlights the error of the Third Circuit's decision.

CONCLUSION

The issue raised in this matter is of considerable significance in the administration of the federal income tax laws. It has broad and direct application to members of the *Amici*, as well as to other industries. In this case, the Third Circuit has relied upon discredited tax notions while disregarding other valid, acceptable, even mandated tax principles. It has infected the treatment of customer-based intangible assets with substantial uncertainty and has created a direct conflict with decisions of other circuits. For

these reasons, *Amici* respectfully urge that the Court grant the Petition For Writ of Certiorari.

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